# M. STATUTE OF LIMITATIONS FOR EXEMPT ORGANIZATION RETURNS

1. <u>General Rule</u>

IRC 6501(a) provides the general rule that the amount of any tax shall be assessed within three years after the tax return is filed. IRC 6501(b)(1) provides that a return is deemed filed on the due date if it is filed early but is deemed filed on the date filed if it is filed late.

2. <u>Exceptions to the General Rule</u>

IRC 6501(c) lists several exceptions that allow assessment to be made at any time. These include a false or fraudulent return with the intent to evade tax; a willful attempt to evade tax; failure to file a return; and assessment of tax on termination of private foundation status. The statutory period may also be extended by written agreement (on Form 872, Form 872-A, or Form 872-C for private foundations) between the taxpayer and the Service. If the period of limitations is extended by agreement, the tax may be assessed any time within the period agreed on, and the period may be extended by subsequent written agreements made within the period previously agreed on.

IRC 6501(g)(2) and Reg. 301.6501(g)-1(b) provide that the period of limitations starts when an organization, believing in good faith that it is an exempt organization, files a return as such, even if the organization is later held to be a taxable organization for the taxable year for which the return is filed. Rev. Rul. 60-144, 1960-1 C.B. 636, provides that IRC 6501(g)(2) applies even though the organization has not been recognized as exempt when the return is filed. IRC 6501(g)(2) does not, however, relieve an organization that has not established its exempt status from the requirement that it file income tax returns and pay any tax due.

3. <u>What Constitutes a "Failure to File a Return"?</u>

The "failure to file" exception of IRC 6501(c)(3) does not apply to related returns (Form 990-T, Form 1120-POL, etc.) required of an exempt organization if the organization filed in good faith an information return that discloses information sufficient to apprise the Service of the nature and extent of the items that should have been reported on a related return. This has been Service position since the publication of Rev. Rul. 69-247, 1969-1 C.B. 303, which announced that the Service will follow the decision in California Thoroughbred Breeders Association v. Commissioner, 47 T.C. 335 (1966), if certain conditions are met. Service position prior to Rev. Rul. 69-247 was set out in Rev. Rul. 62-10, 1962-1 C.B. 305, which provided that filing an information return did not start the period of limitations for purposes of assessment of unrelated business income tax.

In California Thoroughbred Breeders, the Service attempted to assess unrelated business income tax on an IRC 501(c)(5) organization's income from horse sales. The tax was assessed more than three years after the organization filed Form 990 for the year in issue. The organization did not file Form 990-T for the year, but reported the income from the horse sales on its Form 990. The organization asserted the defense that the three year period of limitations barred assessment. The Service contended that the period of limitations did not apply because the organization did not file Form 990-T, and the filing of Form 990 did not start the period of limitations for assessment of unrelated business income tax. The court held that the period of limitations for assessment of unrelated business income tax on the horse sale income started when the organization filed Form 990, which reported the nature and amount of the income. The court found as fact that the organization determined in good faith that it was exempt and had no taxable income. Therefore, the organization determined in good faith that it was not required to file any return other than Form 990.

In Rev. Rul. 69-247, the Service set out the information an organization's annual information return must disclose to bring the return under the holding of the court in California Thoroughbred Breeders. The return (filed in good faith) must state the nature of the income-producing activity with sufficient specificity to enable the Service to determine whether the income is from a related activity and must disclose the gross receipts from the activity. If the information return does not disclose facts sufficient to apprise the Service of the nature and amount of the income, the Service follows the position of Rev. Rul. 62-10, which is that the filing of the information return does not start the period of limitations for purposes of assessment of unrelated business income tax. When the Service applies the position of Rev. Rul. 62-10, it bears the burden of proof to show the existence of the income, the liability for tax, and that the information disclosed on the information return is insufficient to apprise the Service of the nature and amount of the income.

4. Extension of the Period for Substantial Omissions of Income

IRC 6501(e)(1) gives another exception to the three year period of limitations of IRC 6501(a) for substantial omissions. If a taxpayer omits from gross income an amount properly includible in excess of 25 percent of the gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, any time within six years after the return was filed unless the amount is disclosed on the return or in a statement attached to the return in a manner sufficient to apprise the Service of the nature and amount of the income. With respect to exempt organizations, this exception applies to omissions of unrelated business income.

5. <u>Extension of the Period for Substantial Omissions of Excise Tax Items</u>

IRC 6501(e)(3) provides a similar exception to the three-year period of limitations for substantial omission of excise tax items, including Chapter 41 and Chapter 42 taxes. IRC 6501(e)(3) provides that if a return omits an amount of Chapter 41 or 42 tax exceeding 25 percent of the amount of such tax reported, the tax may be assessed within six years after the return was filed unless the transaction giving rise to the tax is disclosed on the return, or in a statement attached to the return, in a manner sufficient to apprise the Service of the existence and nature of the item.

Proposed Treasury Regs. 301.6501(e)-1(c), 45 Fed. Reg. 56358 (1980), clarify application of the IRC 6501(e)(3) exception. Proposed Reg. 301.6501(e)-1(c)(3)(ii) provides that with respect to any Chapter 42 tax, other than the tax imposed by IRC 4940, if a private foundation or trust discloses an item in its return or in an attached schedule or statement in a manner sufficient to apprise the district director or director of a service center of the existence and nature of such item, the three year limitation on assessment and collection shall apply to any tax arising from any transaction disclosed by the item. If an item is not so disclosed in the private foundation or trust's return or attached schedule or statement, the tax arising from any transaction not so disclosed may be assessed or a proceeding in court for the collection of such tax may be begun without assessment, at any time within six years after the return was filed.

Proposed Reg. 301.6501(e)-1(c)(3)(i) provides a different rule with respect to the tax imposed by IRC 4940. If a private foundation omits from its annual return an amount of properly includible IRC 4940 tax that exceeds 25 percent of the amount of IRC 4940 tax reported, the six year period of limitations applies to assessment or collection.

Proposed Reg. 301.6501(e)-1(c)(2) provides that with respect to Chapter 41 taxes on excess expenditures to influence legislation, if an organization discloses an expenditure in its return or in an attached schedule or statement in a manner sufficient to apprise the district director or director of a service center of the existence of the expenditure, the three year period of limitations shall apply.

6. <u>The Private Foundation's Return Starts the Period</u>

IRC 6501(n)(1) provides that the return required to disclose the items is the private foundation's return. Proposed Regs. 301.6501(n)- 1(a)(1) explicitly provides that, for purposes of determining the period of limitations under IRC 6501, the return of the private foundation is considered the return of all persons required to file a return with respect to any Chapter 42 tax even if all those persons did not sign the return. Thus, in the case of a private foundation, the filing of a Form 990-PF starts the running of the statute with respect to all persons required to file a return with respect to such taxes. This is true even if the foundation (in good faith) incorrectly answers the questions pertaining to Chapter 42 taxes. This provision does not relieve a disqualified person of the responsibility under IRC 6011 to file Form 4720 for any tax due, nor does it relieve a disqualified person of the penalty imposed under IRC 6651 for failure to file. It merely provides that a disqualified person's filing of Form 4720 has no effect on the period of limitations imposed by IRC 6501.

7. <u>Burden of Proof to Show that Three Year Period Does Not Apply</u>

In any case where the Service contends that the three year period of limitations does not apply, the Service bears the burden of proof. If the Service contends that a substantial omission of IRC 4940 tax from a return extends the limitations period to six years, the Service must show that the private foundation is liable for the tax and that the amount of IRC 4940 tax omitted exceeds 25 percent of the IRC 4940 tax reported on the return. If the Service contends that an omission of Chapter 41 tax or an omission of Chapter 42 tax (other than IRC 4940 tax) extends the period of limitations to six years, the Service must show that the private foundation is liable for the tax and that the foundation's return does not disclose the item giving rise to the tax in a manner sufficient to apprise the district director or director of a service center of the existence and nature of the item.

8. <u>How Do We Determine Whether Sufficient Disclosure Was Made?</u>
<u>Court Cases</u>

The determination whether the income, transaction or expenditure was disclosed in a manner sufficient to apprise the Service of the nature and amount of the income or tax is factual. Consequently, factual differences in cases cause different results. However, some leading cases provide guidelines and tests that can help a factual determination.

The leading case is Colony, Inc. v. Commissioner, 357 U.S. 28 (1958), in which the Supreme Court of the United States interpreted 1939 IRC 275(c), which it stated is harmonious with the unambiguous language of IRC 6501(e)(1)(A). The Court examined the legislative history of the period of limitations and concluded that its purpose is to extend the limitations period when a taxpayer's failure to report errors puts the Service at a special disadvantage to detect them. Such a situation exists when a "return on its face provides no clue to the existance of the omitted item." 357 U.S. at 36. If the error is disclosed on the face of the return, the Service is at no disadvantage and no reason exists to extend the limitations period.

In George Quick Edward Trust, 54 T.C. 1336 (1970), aff'd per curiam, 444 F. 2d 90 (8th Cir. 1971), the Tax Court said the key to whether sufficient information is contained on the return is whether the Service is provided a "clue" to the existance of the error. The "clue" must be more than something that would intrigue a "Sherlock Holmes", but it does not need to be a detailed revelation of every underlying fact.

In Electra Radio, Inc., 27 P-H Mem. 589 (1958), the taxpayer had received advance payments for yearly service contracts. It reported the payments as income only as they were earned and did not report as income advance payments on service contracts that were not yet performed. The Service sought to include the advance payments in income for the year received. The period of limitations had passed but the Service argued that the taxpayer had omitted the item from the return and therefore, the six year period applied. The court held, on the basis of Colony, that since the taxpayer reported an item listed as "deferred income on service contracts," the Service was alerted that the taxpayer was deferring some income. Therefore, the three year period applied and assessment was barred.

In Benderoff v. United States, 398 F. 2d 132 (8th Cir. 1968), the court held that where the balance sheet attached to a subchapter S corporation's return disclosed that its beginning balance of the undistributed income account was the same as the amount of distribution to the stockholders during the fiscal year, and that the ending balance was the same as the taxable income for that year, the

Service was given an adequate clue that there had been distribution of the shareholders' undistributed taxable income.

In University Country Club, Inc., 64 T.C. 460 (1975), an IRC 501(c)(7) social club attached to its initial return a balance sheet. The balance sheet showed a capital stock account with two classes of common stock and a capital surplus account. The taxpayer also attached a reconciliation schedule of the capital surplus account that showed the parts of the account that were assigned to general memberships, pool memberships, and golf memberships. The Tax Court has held in similar cases that one of the classes of stock represents the privilege of using the club facilities and therefore, the receipts from the sale of such stock is ordinary income. The court held, however, that assessment of tax on the amount that represented ordinary income was barred by the statute of limitations. Assessment was made after the three year limit, which applied because the taxpayer reported the capital surplus account schedule and included in the schedule all the items that were income related. The court concluded that taxpayer's reporting gave the Service an adequate clue to apprise it of the existance of the income.

In Estate of Lena B. Knox, 30 P-H Mem. 706 (1961), rev'd on other ground, 323 F. 2d 84 (5th Cir. 1963), the taxpayer attached a statement to her 1951 return stating that her only source of income was from apartment buildings in which she acquired a 60 percent interest by court decree dated June 21, 1951. She provided the file number of the case and stated that she had no record of the buildings' value or the proper rate of depreciation to take, but that she was advised by counsel to take depreciation on 60 percent of the current value at 2-1/2 percent a year. The court held that because the return did not mention the cooperation's liquidation, which was the transaction in which she acquired the buildings and was the transaction giving rise to the omitted income, and no amount was included in income as capital gain, the taxpayer had not adequately disclosed the nature and amount of her income for purposes of IRC 6501(e). The statement attached to the return gave the Service notice only that there might be a question about depreciation, and the Service could discover the omitted income only by checking the depreciation. The court concluded that disclosure, to sufficiently apprise the Service, must be more directly related to the omitted income.

In William Thomas, 42 P-H Mem. 1187 (1973), the taxpayers, who were waiters, underreported their tip income. The Service determined, more than three years after their return was filed, that they earned unreported tip income that was in excess of 25 percent of the amount they reported. The taxpayer argued that disclosure was adequate for purposes of IRC 6501(e) because: (1) They disclosed their occupation as waiters; (2) They reported tips in "round figures;" and (3) It is "common knowledge" that tip income is frequently understated. The court held that these factors were not sufficient to apprise the Service of the existance of the income. The court noted that if revealing the type of income, without revealing the amount, was sufficient, the statute would be emasculated.

9. Examples

Two hypothetical assessment situations illustrate application of the principles applied in the cases discussed above. The first situation concerns an IRC 501(c)(3) organization that solicits donations from the general public through direct mail. It offers premiums that vary with the amount of the contribution. The premiums for five and ten dollar contributions are of nominal value, with a retail value of less than a dollar. For contributions of twenty-five dollars, however, the organization gives donors a plaque that has a retail value of about twenty-five dollars and is readily available in retail markets. In the recent case of Disabled American Veterans v. United States, U.S. Ct. of Claims, No. 260-76 (1980), the court held that although premiums of nominal value given to donors in return for contributions do not give rise to unrelated business income, premiums of substantial retail value close to the amount of the contribution give rise to unrelated business income. In our hypothetical case the organization's Form 990 did not list any amount as income from business activities. All amounts received from the direct mail campaign were listed as "Gross Contributions, Gifts, etc." The organization's filing of Form 990 did not start the period of limitations with respect to the unrelated business income tax because the Form 990 did not give the Service a "clue" to the nature and extent of the organization's unrelated business income.

The second hypothetical situation concerns a loan by a private foundation to a disqualified person under circumstances not covered by any exception or transitional rule to section 4941. For the taxable periods involved, the foundation timely filed the Form 990-PF and, in good faith, indicated "no" or "not applicable" to all questions concerning Chapter 42 transactions. There was no indication of the self-dealing event on the return. The filing of the Form 990- PF starts the running of the statute. The six year period of limitations should apply because there was no indication of the self- dealing act on the return.

10. Applicable Period of Limitations for Continuing Chapter 42 Violations

Another current issue concerns the applicable statute of limitations governing the assessment of self-dealing taxes under IRC 4941 in situations involving a continuing transaction. IRC 4941(a) imposes an initial tax on the self-dealer and any participating foundation manager for each act of self-dealing between a disqualified person and a private foundation. The initial tax is imposed for each year or part thereof in the taxable period. IRC 4941(e)(1) defines "taxable period" for each act of self-dealing as the period beginning on the date of the prohibited transaction and ending on the earlier of the date of mailing of a statutory notice of deficiency or the date on which correction of the prohibited transaction is completed. Continuing transactions (for example, a lease of property, the lending of money, or an extension of credit) pose statute of limitations questions because they cause more than one act of self-dealing to occur in the taxable period and the proper period of limitations must be determined for each act.

Regs. 53.4941(e)-1(e)(1)(i) provides that in continuing transactions an act of self-dealing occurs on the day the transaction first occurs and an additional act of self-dealing occurs on the first day of each subsequent taxable year of the disqualified person falling within the taxable period. Example (2) under Regs. 53.4941- 1(e)(1)(ii) specifically indicates that the subsequent prohibited acts arising from the initial transaction are treated as separate acts of self-dealing occurring in separate taxable periods. Thus, for a continuing act of self-dealing that occurred in taxable year 1979, the private foundation's return (because of IRC 6501(n)(1)) for taxable year 1979 starts the running of the period of limitations on assessment of all taxes resulting from the act for years in the taxable period, but does not start the period of limitations for the act of self-dealing that occurs on the first day of taxable year 1980, which is the second year in the taxable period. Whether the three year or six year period of limitations applies depends on whether disclosure was made, within the meaning of IRC 6501(e)(3), of the initial act of self-dealing.

11. <u>Example</u>

A hypothetical assessment situation illustrates application of the period of limitations to continuous acts of self-dealing. The situation involves a loan made in 1974 by a private foundation to a disqualified person under circumstances not covered by any exception or transitional rule to IRC 4941. The loan was made in 1974 and was corrected in 1975. The appropriate tax on the self-dealing act is $100. Both the foundation and the disqualified person are calendar year taxpayers. For the taxable periods involved, the foundation timely filed all required returns and indicated "no" or "not applicable" to all questions concerning Chapter 42 transactions. The disqualified person did not file Form 4720. The only indication of the self-dealing event was the listing of the loan note among the foundation's assets on Form 990-PF, without any description of the relationship or identity of the note's maker.

In this hypothetical situation, the foundation's return for 1974, which was timely filed and thus deemed filed on the due date of May 15, 1975, starts the six year period running for all taxes resulting from the 1974 act of self-dealing for each year or part thereof in the taxable period. The taxes due for each year or part year in the taxable period, which ended when the act of self-dealing was corrected in 1975, are $100 for 1974, and $100 in 1975. The period of limitations expires for these amounts on May 15, 1981, which is six years after the foundation's return for 1974 was deemed filed.

The period of limitations for the act of self-dealing that occurred on the first day of 1975 (because the initial act was a continuing transaction) expires on May 15, 1982, six years after the foundation's return for 1975 was deemed filed. With respect to this second act, no taxes other than the initial tax of $100 are due because the act of self-dealing was corrected in 1975, thus ending the taxable period. The total taxes due for both acts of self-dealing were $300.

The six year period of limitations rather than the three year period should apply to the transaction because the mere listing of the note among the foundation's assets on Form 990-PF, without any description of the relationship to or identity of the note's maker, does not adequately disclose to the Service that an act of self-dealing occurred. If the identity of the maker and the relationship of the foundation to the note's maker were disclosed on the return, the Service would have been sufficiently apprised of the act of self- dealing and the three year period would apply.